STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	)	
	)	
Proposed General Increase	)	No. 07-0241
In Rates for Natural Gas Service	)	
	)	
	)	
THE PEOPLES GAS LIGHT AND	)	
COKE COMPANY	)	
	)	
Proposed General Increase	)	No. 07-0242
In Rates for Natural Gas Service	)	

REPLY BRIEF ON EXCEPTIONS OF THE CITY OF CHICAGO AND THE CITIZENS UTILITY BOARD

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[1] "PGL" = Peoples Gas. "NS" = "North Shore". Use of these acronyms in a parenthetical means the issue relates only to the referenced utility.

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REPLY BRIEF ON EXCEPTIONS OF THE
CITY OF CHICAGO AND THE CITIZENS UTILITY BOARD

Pursuant to Section 200.830 of the Rules of Practice[2] of the Illinois Commerce Commission ("Commission" or "ICC") and the briefing schedule set by the Administrative Law Judges ("ALJ") in their November 26, 2007 Administrative Law Judges' Proposed Order ("ALJPO"), the CITY OF CHICAGO ("City") by its attorney, Mara S. Georges, Corporation Counsel, and the CITIZENS UTILITY BOARD ("CUB") (collectively "City-CUB") submit their Reply Brief on Exceptions to the ALJPO in this proceeding. The sections of this brief are organized in accordance with the outline of issues submitted to the Administrative Law Judges ("ALJ") on September 21, 2007.

II. RATE BASE

D. Reserve for Accumulated Depreciation and Amortization

Staff's Brief on Exceptions ("BOE") presents a candid and thoughtful account of the circumstances and analysis that led it to reverse its position to support balancing *pro forma* plant

additions with known and measurable changes in the other component of rate base, accumulated depreciation. Staff faced the same array of disparate Commission decisions on this issue that the ALJPO recognizes. Staff's response was to re-examine its former position and the supporting arguments. Staff asks the Commission to undertake a similar reassessment, noting:

> [E]ach time an issue is presented and analyzed, a deeper and clearer understanding of the issue and its implications may be realized. Such is the position that Staff finds itself with regard to this issue.

Staff BOE at 2.

In their BOE, the Companies took a different tack. The Companies looked for an easy answer – a single case to mimic – instead of undertaking reasoned analysis of the test-year concepts the decisions purport to implement. The ALJPO follows that unfortunate lead.

The certainty the ALJPO seeks to achieve (ALJPO at 17) can be attained only by following Staff's recommendation. The Commission must reassess the position the ALJPO adopts and assure that its decision restores balance and representativeness to the test-year process. By simply choosing among past decisions to mimic (as the Companies argue), the Commission countenances unpredictable results that reflect no coherent principle. That does not enhance the certainty or clarity of Commission precedent. The Commission should take this opportunity to provide a clear statement of governing test-year principles.

Staff's application of test-year principles to the evidence in this record is also on the mark. "Mr. Effron's adjustment is necessary so that net plant-in-service is reflective of the costs and revenues that will be in place for the period during which rates are in effect, a characteristic that the Companies agree is appropriate for pro forma adjustments. (Sep. 10, 2007 Tr. at 130)."

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[2] 83 Ill. Adm. Code Part 200.

Staff BOE at 3. Staff recognizes that without that adjustment [the ALJPO's] net plant-in-service balance is overstated by at least $48 million. *Id.* at 4.

The Companies use the same flawed arguments as the ALJPO, which were anticipated in Staff's BOE. "On one hand the PO approves the Companies' proposed adjustment to convert the historical test year to a future test year for plant additions, yet rejects the GCI adjustment to update the accumulated depreciation on embedded plant because the adjustment converts the historical test year to a future test year. The same reasoning cannot have merit in one situation and lack merit in another situation." *Id.* at 4.

The Companies, like the ALJPO, cite no evidence that demonstrates the matching and representativeness required by the test-year concepts defined in governing judicial and Commission precedent. The balanced approach to *pro forma* adjustments codified in the Commission *pro forma* rule is the diametric opposite of the Companies' self-serving adjustment for only one of the components of rate base. The Companies can only repeat arguments discredited by the evidence to support the ALJPO's flawed conclusion.

City-CUB support Staff's recommendation that the focus of future cases should be whether (a) test year net plant-in-service, with balanced adjustments for plant additions and accumulated depreciation, or (b) test year net plant-in-service, adjusted for plant additions alone, is more representative of the actual balance for the period when rates would be in effect. Staff BOE at 6.

There is no reason to delay application of that test. It is the question to ask in this case, and the record is clear. The Companies' anomalous and unbalanced adjustment for plant

additions alone is not representative of what the rate base will be when the rates approved here are in effect.

II. RATE BASE

G. OPEB Liabilities and Pension Asset/Liability

The ALJPO correctly accepted Mr. Effron's adjustment to rate base for accrued OPEB liabilities. However, the ALJPO's action offsetting the adjustment with test-year payments by the Companies was not correct. In their BOE, the Companies contest the first action, they defend the second, and they ask for even more by seeking rate base treatment of their pension assets and liabilities. These issues are addressed separately below. The Companies' further request to include pension assets in rate base is wholly unsupported.

OPEB Liability Adjustment. The Companies continue to contest the OPEB liabilities adjustment the ALJPO adopts. The Companies do not deny the facts on which Mr. Effron and Ms. Pearce rely for the OPEB liabilities adjustment – *viz.*, that the OPEB accrued liability represents cost-free capital supplied by ratepayers, not investors. *See* PGL-NS BOE at 14-17. They argue -- albeit loudly -- ***only*** that the Companies made payments or contributions to the plans in the test year. *Id.* at 15. However, the relevant fact in determining whether to include this amount in rate base is not what entity made the payment, but the source of the funds for the pension contributions. If the contributed funds do not represent ***shareholder investment***, then the Companies are neither entitled to nor allowed a return on those funds. 220 ILCS 5/9-211.

The ALJPO rejects the Companies' objections to the OPEB liability adjustment and reached the correct result by accepting Mr. Effron's proposal. ALJPO at 35. The Companies'

currently effective rates recover the utilities' periodic pension costs, based on the test year amounts for that expense. Staff Ex. 14.0 at 22. When the amounts collected exceed actual payments for pension obligations, there is an accrual to the Companies' OPEB liabilities. *Id.* at 21. That excess of pension costs collected from ratepayers is the amount on which the Companies argue they should be entitled to earn a return for shareholders.[3] Staff and City-CUB recognize those funds as ratepayer-supplied, and thus not properly included in rate base.

Contributions Offset. The ALJPO's further action (at 36) treating the Companies' contribution of funds collected from ratepayers (through rates set to cover pension costs) as shareholder investment is inappropriate and unlawful. The Companies try to distinguish the cases Staff cites in opposition to the ALJPO's conclusion by noting that the involved utilities had not made contributions in certain years.[4] As shown above, that allegedly distinguishing fact is irrelevant to the issue at hand and, thus, not distinguishing in any meaningful way. The recognition that the excess collections from ratepayers recorded as OPEB liabilities are not shareholder investment does not depend on the presence of utility plan payments in a particular year. Accordingly, the ALJPO's offset of contribution amounts against the OPEB liabilities adjustment should be rescinded and Mr. Effron's adjustment adopted without modification.

Pension Assets/Liabilities. In addition, the Companies continue to seek rate base treatment of pension assets and liabilities. PGL-NS BOE at 16. The Companies' witness Ms.

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[3] The Companies attempt to confuse the issue further by expanding the universe of possible offsets to include PGL's "entire pension asset" and NS' "pension liability." PGL-NS BOE at 14. The Companies' non-rate base pension assets and liabilities (*see* Staff Ex. 14.0 at 22) are wholly unrelated to this assessment of the nature of the excess collections recorded as accrued OPEB liabilities.

[4] Referring to *In re N. Ill. Gas Co.*, ICC Docket No. 04-0779, Order at 22 (Sept. 20, 2005), and *In re N. Ill. Gas Co.*, ICC Docket No. 95-0219, 1996 Ill. PUC Lexis 204, *20 (Apr. 3, 1996).

Kallas testified that "the same arguments used by Mr. Effron for including the OPEB liability are applicable to the pension balances" (PGL-NS Ex. LMK-2.0 at 13) and that if OPEB liabilities are a reduction in rate bases because the utility controls ratepayer-supplied funds, then pension assets/liabilities should be additions to rate base (PGL-NS Ex. LMK-3.0 at 3).

By straining to portray the two quantities as warranting the same treatment, Ms. Kallas affirms why they do not. Mr. Effron's arguments apply to pension assets/liabilities only if they are ratepayer-supplied funds. Similarly, citing utility control of ratepayer supplied funds as a basis for the Companies' argument affirms that the funds are, in fact, ratepayer-supplied. The pension assets/liabilities are, therefore, legally barred from inclusion in rate base. 220 ILCS 5/9-211. In contrast, the OPEB liability adjustment serves the same purpose as section 9-211 of the Act: it excludes from rate base (and precludes a return on) funds that are not shareholder "investment."

Possibly in recognition of the validity of City-CUB criticism (*see* City-CUB Reply Br. at 2, 18), the Companies have abandoned their reliance on *In re Commonwealth Edison Co.*, ICC Docket No. 05-0597 (July 26, 2006) (cited in PGL-NS Init. Br. at 33). *See* PGL-NS BOE at 15-16. Now, the Companies' search for a favorable decision has led them to a 1994 case, *In re Cent. Ill. Light Co.*, ICC Docket No. 94-0040 (Dec. 12, 1994) ("*CILCO*"). PGL-NS BOE at 16. In that case the Commission approved inclusion of a pension asset in rate base because, as the Companies' own brief notes, the utility "had made pension plan contributions and the inclusion

was not a contested issue." *Id.*

Thus, it is clear that the Companies' principal authority for its position is not authority at all. The Commission in *CILCO* never considered the arguments against inclusion of pension assets in rate base, because none were made; it was not a contested issue. In other cases discussed in this record, the Commission's decision on rate base treatment of pension assets/liabilities has been consistent with that adopted by the ALJPO. In other words, the Commission in *CILCO* never considered the issue for which the Companies cite that decision as authority.

III. OPERATING EXPENSES

C. Contested Issues

3. Administrative & General Expenses

b. Incentive Compensation Expenses

The Companies' arguments respecting incentive compensation expenses are at times disingenuous, and at others, simply misguided. For example, the Companies argue that "[t]he Commission should approve all of the incentive compensation program costs and expenses included in the Utilities' proposed revenue requirements." PGL-NS BOE at 18. There is little doubt that the Companies are aware of the amount of their request. Yet, despite arguing for this position, in their proposed exceptions language the Companies adopt the larger – and clearly erroneous –(*see* City-CUB BOE at 26) – IPB amounts granted in error by the ALJPO. PGL-NS Exceptions at 18; *see also* ALJPO at 67.

The Companies also assert that "[n]o witness challenged Mr. Hoover's testimony . . . that these costs benefit a utility's customers by 'maintaining and improving quality of work.'"

PGL-NS BOE at 18. But, whether incentive compensation ***could*** theoretically benefit customers was never the issue in this case. The parties opposing the Companies' requested expenses questioned whether the Companies actually had shown the "tangible and quantified benefits" the Commission's prior decisions have required. *See, e.g.*, ALJPO at 63. Only through such a showing can the Commission be assured of real, and not just theoretical, causality between the incentive payments and claimed customer benefits. That required showing also is effective in avoiding realization of the concerns expressed in Staff's BOE -- that claimed incentive pay expenses are either not made or altered in ways that diminish or eliminate customer benefits. *See* Staff BOE at 22-23. In such circumstances, the Commission cannot change rates as facilely as the Companies can change its plans. Remedial Commission action is barred by the prohibition against retroactive ratemaking if the allowed expenses turn out to be more than appropriate, whether because of a change in plan criteria or in plan implementation.

City-CUB seconds Staff's support for the ALJPO's conclusion that "While these plans may indeed be necessary 'to attract and retain a qualified workforce' this is not reason enough to allow the expense." ALJPO at 66; Staff BOE at 22. The theoretical benefit of such plans does not establish the particular amounts that yielded the benefits, nor does it demonstrate the reasonableness of the amounts requested.

The Companies respond to the ALJPO on this point by attacking a distortion of the ALJPO's conclusion: "The Utilities respectfully submit that there is no valid basis for 'disqualifying' attracting and retaining a qualified work force as a grounds for approving prudent, reasonable, and needed costs and expenses." PGL-NS BOE at 19. First, the ALJPO does not disqualify attracting and retaining qualified employees as a basis for approving

expenses. Second, the challenge to the Companies' expenses on this record are on the grounds the Companies simply ***assume***, but have not shown. They have not demonstrated that the requested expenses are, in fact, prudent and reasonable. Prudence would be shown by the tangible, quantified benefits the Commission has required in prior decisions; reasonableness of the expenses and amount can be assessed only in the presence of quantified benefits. *See* City-CUB Init. Br. at 18-19.

The Companies' arguments (and the ALJPO's acceptance of them) should be rejected and the ALJPO revised to recognize that the Companies have not made the requisite showing of tangible, quantified benefits to ratepayers from the incentive payments.

IV. RATE OF RETURN

C. Cost of Common Equity

1 & 2. Peoples Gas/North Shore

The Companies open the cost of equity section of their BOE with two arguments that ask the Commission to break the law. First, the Companies ask that the Commission's cost of equity determination take account of various effects of their merger[5] with Integrys (including their unregulated affiliates) – despite the unambiguous prohibition on including in rates any cost of capital increment attributable to unregulated activities. The Companies apparently paid no heed to the ALJPO's restatement of the applicable law.

> However, the Utilities failed to address an important issue raised by Staff - that the Utilities' credit ratings have been impacted by non-regulated

[5] Specifically, the Companies refer to numerous commitments made by Integrys to facilitate approval of the merger, suggesting that they are relevant to the Commission's determination.

> activities. Section 9-230 of the Act requires the Commission to ensure that such activities are not reflected in the authorized rate of return. While the Utilities agreed an adjustment to the embedded cost of debt was necessary to remove the impact of non-regulated activities, their recommended return on common equity does not appear to reflect such an adjustment.

ALJPO at 93-94.

In addition, the Commission has recently stated:

> We hold that if a utility's exposure to risk is one iota greater, or it pays one dollar more for capital because of its affiliation with an unregulated or nonutility company, the Commission must take steps to ensure that such increases do not enter in its ROR [rate of return] calculation.

In re Commonwealth Edison Company, ICC Docket No. 05-0597, Order at 128 (July 26, 2006) (*quoting Ill. Bell Tel. Co. v. Ill. Commerce Comm'n*, 283 Ill. App. 3d 188, 206-07 (1st Dist. 1996)). The governing law could not be clearer. The Companies' decision to ignore it does not provide any reason to deviate from its requirements.

Second, the Companies return, inappropriately, to their comparisons to returns authorized for other utilities, with different characteristics, at other times, on different records. The Companies simultaneously seek to assure the Commission that they are not arguing for a cost of equity based on the authorized returns of other utilities, while at the same time they ask the Commission to do exactly that.

> To be clear, the Utilities are not arguing that their returns should be based on the authorized returns of other utilities. Rather, such returns collectively provide a guidepost against which to compare the analyses and positions taken by Staff and the other parties.

PGL BOE at 25.

And the Companies add:

> For this Commission to set the Utilities' ROEs at levels some 100 basis points below the level generally received by other gas utilities and

> Integrys' other regulated subsidiaries would send a strong signal to the financial market . . .

PGL BOE at 26.

The Companies' BOE also contains surprising, disingenuous arguments that stretch the evidence of record or are inconsistent with the law.

In particular, the Companies claim the financial leverage upward adjustment that their witness Mr. Moul proposed (and the ALJPO rejected) is not a market-to-book adjustment "of the type rejected by this Commission in the past." PGL-NS BOE at 30. That claim is flatly contradicted by the record -- indeed, by the Companies' own expert. Mr. Moul expressly confirmed (City Cross (Moul) Ex. 5) that his adjustment is equivalent to applying the unadjusted ROE to the appreciated market value of all shares, instead of to their book value, which is the amount actually invested in utility service. *See* ALJPO at 93 ("The book value capital structure reflects the amounts of capital a utility actually utilizes to finance the acquisition of assets . . ."). In fact, Mr. Moul's adjustment is mathematically identical to the adjustment that the Commission rejected in the most recent Ameren rate case (ICC Docket No. 06-0070, Order at 141 (Nov. 21, 2006)). Like its equivalent, Mr. Moul's adjustment would allow the Companies to earn unlawfully on more than their authorized rate base amounts. As shown in City-CUB's prior briefs, the leverage adjustment should be rejected.

The Companies attempt to distinguish these mathematically identical adjustments by insisting that Mr. Moul's adjustment "is not intended" to maintain a certain market-to-book ratio – notwithstanding its actual effect. PGL-NS BOE at 31. Similarly, they suggest that Mr. Moul's use of a different name for, or description of, his adjustment nullifies its mathematical identity with the adjustment the Commission rejected. These arguments elevates the

Companies' reliance on subjectivity in its cost of equity determinations to a new level, one where the analyst's claimed intent or clever description is more important than the rate-base and just-and-reasonable rate constraints of the Act.[6]

At different points in a single paragraph on the cost of equity determination, the Companies argue that (a) the closeness of particular averaged estimates is coincidental and meaningless, and (b) averages of quantities that are too far apart cannot be meaningful. PGL-NS BOE at 27. That is result-driven analysis. The Companies' witness Mr. Moul added extra, higher estimates in his average-of-different-model result, boosting his resulting recommendation. *See* City-CUB Init. Br., App. A. The Companies have followed that lead in cobbling together different combinations of estimates that support its desired higher ROE. PGL-NS BOE at 28-30. This result-driven analysis deserves no weight in the Commission's deliberations.

VI. WEATHER NORMALIZATION

The Companies' principal argument against the ALJPO's conclusion that a 12-year sample period should be employed is that no party recommended it. PGL-NS BOE at 39. The ALJPO's decision was based on evidence of predictive accuracy and the reasonable conclusion that an eight-year period is too short to capture Illinois' weather variations. *See* City-CUB Init. Br. at 66-67. Contrary to the Companies' apparent belief, the Commission's decisions must be based on the evidence of record, taken as a whole. 220 ILCS 5/10-201(e)(iv)A. The

[6] The Companies also remark that no party disputed Mr. Moul's specific adjustment for financial leverage. PGL-NS Exceptions at 29. This characterization is inexcusably disingenuous. The argument is the equivalent of saying no witness disputed Mr. Moul's claim that the dragon was green, when every other witness says that there was no dragon.

Commission cannot restrict itself to choosing one of the results specifically recommended by a party. *See* PGL-NS BOE at 39.

Astonishingly, the Companies suggest that its neighbor Nicor's 10-year normalization period is a reason to adopt the same period for the Companies.[7] PGL-NS BOE at 40. Consistently to this point, the Companies have rejected the idea of a common sample period and HDD estimate for utilities in the same weather region. *See, e.g.*, Sep. 12, 2007 Tr. at 886. In fact, the Companies' proposal is offered in place of Nicor's ten-year period and the HDD estimate the Commission approved for Nicor. *Id.*

Self-serving demands for a utility's own weather prediction -- different even from a neighboring or collocated utility's -- are a predictable consequence of the ALJPO's decision. That it is seen already, in this case, is even more reason to initiate the proceeding City-CUB have recommended to establish procedures that preclude gamesmanship in the determination of heating degree days and cooling degree days.

VII. NEW RIDERS

B. Rider VBA and WNA

(i) Need for Statement of Law and Policy.

In its BOE, Staff recognizes the importance of the issues surrounding the proposed revenue assurance riders and urges the Commission to "reconsider the decision to 'pass' on the legal issues." Staff BOE at 67. On this point there is clear consensus among the parties addressing the riders in their briefs. *See* PGL-NS BOE at 42 ("The Utilities request the

[7] The Companies' BOE suggests – based mainly on an unfavorable result – that the ALJPO is biased against the Companies. *See* PGL-NS BOE at 40 ("The Proposed Order recommends . . . a 12-year average, which is simply the least favorable . . . to the Utilities.")

Commission to take this issue on now . . . ."); AG BOE at 16-17. City-CUB believe that a clear, well-reasoned statement of Commission policy and of the governing law in this case would be both timely and appropriate. As Staff observes, "parties have invested considerable effort in addressing these legal issues and related facts, and Staff can discern no compelling reason to defer addressing these issues." Staff BOE at 67. To the contrary, there are compelling reasons for the Commission to confront the issues immediately.

The proposed revenue assurance riders are not merely a "new rate design approach," as the Companies claim. They represent a giant step toward abandonment of traditional rate of return regulation. The extent to which revenue guarantees through riders would be a fundamental change in the nature of regulation in Illinois cannot be overstated.

Revenue riders do not track specific cost elements underlying a utility's rates. Rather, they would substitute for the entire rate case slate of reviewable costs. In particular, the per-customer revenue focus of the Companies' proposed riders purports to cover all cost items, except for a few specifically excluded costs and revenues that generally inure to the utility's benefit. Under this construct, the policy constraints of the governing case law, which permit riders only for certain types of costs, would become meaningless.

Imposing rider recovery of a guaranteed level of revenues for utilities is a change in the basic nature of the Commission's regulation. Such a fundamental modification of the statutory regulatory regime established by the General Assembly is beyond the Commission's jurisdiction. *Compare with A. Finkl & Sons v. Ill. Commerce Comm'n*, 250 Ill. App. 3d 317, 327-28 (1993) . No other party supports the Companies in their advocacy of this change.

The fully applicable, consequential prohibitions against single-issue ratemaking and retroactive ratemaking are not even addressed in the Companies' BOE. The judicial bar against single-issue ratemaking, which constrains Commission ratemaking in this context, is covered well in the ALJPO. *See* ALJPO at 144-47. That legal analysis will not be repeated here. There is clear applicability to the proposed riders of this legal restraint on singling out specific costs as the basis for rate changes, without consideration of offsetting cost or revenue changes. The ALJPO also captures the persuasive discussion of the impact of the prohibition against retroactive ratemaking that was presented in briefing by Staff. *See* ALJPO at 121. As Staff summarized its impact here, "the PUA 'prohibits refunds when rates are too high and surcharges when rates are too low.'" *Id.* at 121 (quoting *Bus. & Prof'l People for the Pub. Interest v. Ill. Commerce Comm'n*, 136 Ill. 2d 192, 209 (1989)). That is precisely how the proposed revenue assurance riders would unlawfully operate.

The disconnect between the evidence of record and the Companies' assertions suggests that the rider proposals are not driven by a need to manage serious cost pressures that are beyond utility control or by a desire to advance energy efficiency, as the Companies claim. Instead, the proposals – which the evidence shows would greatly benefit the Companies and their investors, at ratepayers' expense, *see, e.g.*, City-CUB Reply Br. at 41-42 – appear to be a tactic to guarantee a predictable revenue stream. Revenue assurance riders may be the latest item in a string of utility strategies to shift risk from investors (who are compensated for taking risks) to captive customers. (The recent procurement riders experience and the increasing number of cost-tracking riders spring to mind.) Such mechanisms also bypass the Commission's rate-setting function and avoid the scrutiny of regulatory oversight. Available evidence suggests

a widespread (curiously similar) effort by utilities across the country to avoid the scrutiny of rates cases through the wholesale adoption of tariff riders of varied descriptions.

Active regulation of rates and meaningful Commission oversight are the protection for monopoly utility ratepayers the General Assembly established. Both the wisdom and the lawfulness of eviscerating that process (by exempting significant costs of service or entire revenue streams from scrutiny) is dubious at best.

(ii) The Companies' Legal Arguments.

The Companies begin their legal argument by attempting to show that the Commission's authority and discretion are virtually unlimited. They pursue that argument despite an apparent recognition that Commission and judicial decisions in Illinois have neither considered nor established Commission authority to approve ***revenue*** riders, and that the proposed riders carry significant risks for ratepayers . PGL-NS BOE at 41. Yet, the Companies argue, based primarily on *City of Chicago v. Ill. Commerce Comm'n*, 13 Ill.2d 607 (1958) ("*City I*"), that the only real limitation on Commission authority to approve riders is the Commission's own discretion. They find this authority in the mere absence of ***express*** prohibitions -- "nothing in past Illinois rider cases proscribes the inclusion of revenues in rider recovery." PGL-NS BOE at 42, n. 9. The Companies fail to note there that neither Illinois courts nor this Commission have ever had occasion to issue such a ruling, as this is a "proposal of first impression." *Id.* at 41.

The Companies then ask the Commission to exercise this conjured unbridled authority to approve their proposed revenue assurance riders. Contrary to the Companies' assurances, the

Commission's authority is not unbounded, and the proposed revenue riders are not consistent with the limiting criteria defined by governing Illinois precedent.

The Companies' new legal arguments rest on the ***words*** in a single decision (*City I*), setting aside the consistent reasoning of subsequent judicial and Commission rider decisions. The utilities's arguments discard the teaching of more recent decisions. That body of Illinois law recognizes (1) limits on the types of costs allowed rider recovery and (2) legal prohibitions against single-issue ratemaking and retroactive ratemaking that circumscribe the Commission's actions with respect to riders. *See A. Finkl*, 250 Ill. App. 3d at 325-26.

The line of decisions since *City I* reflect an evolution in Illinois law and policy respecting tariff riders that constrains the discretion described in *City I*. Those decisions, which apply here, provide clear and consistent guidance. The governing case law, including *City I*, accepts riders only as exceptions to the regularized process of economic review established to satisfy the Commission's statutory ratemaking responsibilities. *See Citizens Utility Bd. v. Ill. Commerce Comm'n*, 166 Ill. 2d 111, 137-38(1995)*; City of Chicago v. Illinois Commerce Comm'n*, 13 Ill. 2d 607, 608-609, 614 (1958); *Ill. Power Co. v. Ill. Commerce Comm'n*, 339 Ill. App. 3d 425, 434 (1st Dist. 2003). Riders that excuse a utility's obligation to prove the prudence and reasonableness of its expenditures in rate cases must be justified by the "burden imposed upon a utility in meeting unexpected, volatile or fluctuating expenses" that are material and beyond the utility's control. ALJPO at 145 (quoting *A. Finkl v. Ill. Commerce Comm'n*, 250 Ill.App.3d 317 (1993)).

The Companies pay lip service to limits on Commission authority, but reject any substantive constraint. They argue that the "operation of a mathematical formula that would be

applied to margin revenues" under Rider VBA is the type of mechanism the court endorsed in *City I*. PGL-NS BOE at 45-46. The Companies ignore, again, that the court approved the recovery of specific ***costs***, not a guarantee of revenues. *See* PGL-NS BOE at 46 (*quoting City I* at 613). The Companies' interpretation of the court's decision is overbroad; indeed, under the Companies' formulation – "where an adjustment mechanism is a rate schedule approved by the Commission which contains a mathematical formula for making future changes in the rate schedule, it is not unlawful under the Act" – multiplying rates in concert with phases of the moon would be acceptable. *Id*.

In a belated acknowledgment of later cases, the Companies comment on the ALJPO's analysis of *A. Finkl & Sons Co. v. ICC*, 250 Ill. App. 3d 317 (1st Dist. 1993) ("*Finkl*"). The Companies again find authority in the absence of an explicit rejection, even where there was not reason to address their issue.

> While the *Finkl* case rejected the particular rider at issue there, the fact that the rider in question would recover revenues was neither argued nor decided. *Finkl* involved a proposal by Commonwealth Edison to recover lost revenues pertaining to a demand-side management program in a proposed Rider 22. The Court rejected Rider 22 because it found that the costs associated with the lost revenue were not "unexpected, volatile or fluctuating expenses which Edison cannot control . . .". Finkl, 250 Ill. App. 3d at 327. There was no rejection of Rider 22 in Finkl because it involved "revenues." Indeed, the *Finkl* Court did not seem concerned at all that Rider 22 involved lost revenues and the Court mentions this feature numerous times in the decision without criticizing or rejecting that aspect of Rider.

PGL-NS BOE at 43-44. Again, the Companies' reading of a decision is overbroad. Their logic could find authority for anything the court did not address. By "proving" too much, they prove nothing.

The Companies' assurances that the Commission's legal authority is virtually unlimited are in error. The strained factual parallels and legal *non sequiturs* offered in the alternative, to meet the requirements of governing case law on riders, are inadequate to support the proposed revenue assurance riders.

(ii) The Companies' Fact Arguments.

Like their legal arguments, the Companies' BOE arguments on factual matters ignore inconvenient truths. They also begin these arguments with an unsupported leap to a preferred, but erroneous, conclusion. The Companies' BOE argues that "[t]here is nothing that supports the conclusion that Rider VBA is fundamentally different than any rider that has been authorized by the Commission." PGL-NS BOE at 43. The Companies would thus ignore – and have the Commission ignore – obvious differences between (a) the recovery of the costs of providing regulated utility services and (b) a guarantee of revenues, whether or not costs are incurred or service is provided. Based on this ***assumed*** equivalence of cost recovery and a revenue guarantee, the Companies contort prior decisions to support their revenue assurance proposals.

The false characterization of equivalence, however, is too much even for the Companies to sustain. The Companies admit their contrivance:

> The Proposed Order correctly notes that Rider VBA is a decoupling mechanism proposal of first impression before the Commission and that the purpose of Rider VBA is to hold utility margin revenues constant despite changes in customer consumption. PGL-NS BOE at 41 (emphasis added).

Like the Companies when their guard is down, City-CUB do not agree that there is nothing to distinguish cost recovery and revenue guarantees. The distinguishing element here is the evidence of record. The record in this case establishes the disparate objectives, impacts, and

legal issues of the distinctive types of riders. *See, e.g.*, Staff Init. Br. at 166-68; City-CUB Reply Br. at 40-41.

Equally important are the legal precedents that (a) recognize the differences the Companies wish to deny and (b) disprove the Companies' assumption that the Commission can, or should, equate cost recovery and revenue assurance. The Commission's cost-based regulation of tariff rates (including riders) is founded in its constitutional obligation to provide regulated utilities with a reasonable opportunity to recover their costs (including profit) of providing utility services. The opportunity for cost recovery is constitutionally guaranteed. A guarantee of desired revenues is expressly excluded from constitutional protection.

In *Bluefield Waterworks Improvement Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 279 (1923), the U.S. Supreme Court established that a utility's rates should reflect the opportunity – not a guarantee – to earn a return on its used and useful property dedicated to the public utility enterprise. In *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1941), the Supreme Court reaffirmed that "regulation does not insure that the business shall produce net revenues." *See also Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S.575, 590 (1942). Moreover, the U.S. Supreme Court has expressly rejected the notion that a monopoly must be protected from the effects of price on a consumer's demand and use of the service: "Even monopolies must sell their services in a market where there is competition for the consumer's dollar and the price of a commodity affects its demand and use." *Market St. Ry. Co. v. Railroad Comm'n*, 324 U.S. 548, 568 (1945). Such market forces, competition for customers' limited dollars and against the savings offered by more efficient usage, are cited by the

Companies as reasons for their proposed revenue assurance riders. *See, e.g.*, PGL-NS BOE at 49-51

The Companies' BOE also challenges the ALJPO's well-supported finding that the revenue assurance riders are not necessary. *Id.* at 51. The record evidence, however, does not demonstrate any need for a dramatic departure from base rate recovery. *See generally* City-CUB Init. Br. at 71-75; AG Init. Br. at 58-62. The Companies' recent financial history shows that, using base rate recovery, the Companies have enjoyed stable (not volatile) revenues and returns at or above authorized levels for extended periods. This financial performance has been achieved despite a decades-long trend of declining per customer usage and lower margin revenues -- the very factors the Companies assert that Rider VBA is meant to address. City-CUB Init. Br. at 79-81. As the ALJPO finds, "the urgency to act on a decoupling mechanism such as Rider VBA proposal is not yet upon us," pointing to helpful rate design and weather normalization changes. ALJPO at 133.

The Companies' other factual arguments in support of its revenue assurance riders VBA and WNA also repeat discredited assertions, ignoring the evidence of record. For example, the Companies continue to argue that Rider VBA is symmetrical (correcting rates up or down as needed). *See* PGL-NS BOE at 45-46. As discussed in parties' initial briefs, the evidence shows that the symmetry is purely theoretical. Under the weather conditions the Companies cite in support of their revision of the Commission's weather normalization practices, the riders will operate, not symmetrically, but decidedly in favor of the Companies. Rider VBA or Rider WNA can reasonably be expected to add surcharges, not credits, to customer bills. According to the evidence, had Rider VBA been in effect from 2002 to 2006, the Companies would have collected

from ratepayers an additional $242 million in pre-tax revenues in Rider VBA surcharges. *See* City-CUB Init. Br. at 80-81.

The Companies also claim that they suffer revenue decreases due to the effects of energy efficiency and rising prices and regular over-recovery and under-recovery due to unpredictable weather. PGL-NS BOE at 43. These factors, however, do not warrant approval of Rider VBA. The record shows that despite the effects of weather and a decades-long decline in per customer usage, the Companies' have been able to earn near or significantly more than their authorized return for most recent years. GCI Ex. 1.0 at 18.

As noted earlier, imposing riders to assure recovery of a desired level of revenues is a drastic change in the very nature of the Commission's regulation of utilities. Such a fundamental modification of the statutory regulatory regime established by the General Assembly is beyond the Commission's jurisdiction. Compare with *Ill. Bell. Tel. Co. v. Ill. Commerce Comm'n*, 203 Ill. App. 3d 424, 436 (2d Dist. 1990).

The Companies repeat their plea to the Commission to follow the very few states that have approved revenue assurance riders of some sort. The ALJPO correctly observes that the particulars of their adoption (*e.g.*, governing statutes, settlement terms) and the experience with them are crucial considerations that are not addressed by the evidence in this record. ALJPO at 132. The Companies' BOE mocks this concern as "devolv[ing] into defensive discussion of 'safeguards', pilot programs, studies, and legislative encouragement." PGL-NS BOE at 42. City-CUB are confident that the Commission will take its decisional responsibilities more seriously.

Perhaps recognizing the absurdity of that posture, the Companies try to address the ALJPO's concerns by proposing for the first time in their post-record, post-ALJPO brief on exceptions, some form of experimental or pilot rider approval. No definition or details are provided except to note the Commission's authority to impose ratepayer "protections." *See* PGL-NS BOE at 50-51. No such protections are identified in the record; there is no evidence on the effectiveness of any such protections; and there is no record evidence that could be the basis for specific rider protections. The record contains no evidence that defines or justifies the Companies' last-minute, post-record proposal for a Rider VBA pilot or experiment. *See id.* at 43, 50.

At the end of the day, the Companies ask the Commission to complete its proposal for them. They ask that the Commission define those ratepayer protections that would induce the Commission to approve Rider VBA. If, however, the Commission deems such protections essential to approval of the revenue assurance riders, lacking any record support for additions to the proposed riders, the riders cannot be approved.

For these and the additional reasons discussed in City-CUB's briefs, the Commission should adopt the ALJPO's conclusion that, even if they were lawful, the proposed revenue assurance riders should rejected.

D. Rider EEP (Merits of Energy Efficiency Programs and Rate Treatment)

Staff contests the ALJPO's conclusion that approval of the Energy Efficiency Plan ("EEP") is "consistent with the policy goals contained in the Public Utilities Act." Staff BOE at 73. Noting that the Act does not mandate the EEP, Staff contends that the record does not

support approval of the plan. Staff's argument is rooted in its observation that the specific programs to be implemented under the plan are not yet known and its inference that the Commission cannot know that the results of the approved process will be prudent or least-cost. *Id*.

There is recent precedent for the Commissions's approval of rates that incorporate the results of a process that the Commission finds will identify prudent, least-cost expenditures and yield just and reasonable rates. In the recent power procurement case, the Commission approved an auction plan that it found would yield prices that could be incorporated into rates that would be just and reasonable. *In re Commonwealth Edison Co.*, ICC Docket No. 05-0159, Order at 52 (Jan. 24, 2006). Thus, in that case the Commission approved the procurement process over objections essentially identical to Staff's arguments on this issue.

The ALJPO concludes that the EEP's design and implementation processes will provide adequate assurance of prudent outcomes. "As described on record, the proposed governance structure for the program should ensure independence from the Utilities and will likely result in representation of all or substantially all relevant interests. Moreover, the design of the proposed EEP answers Staff's assertion that the program will not necessarily result in prudent expenditures." ALJPO at 169.

The record support for this conclusion is compelling. The ALJPO recounts much of the detail of testimony from witnesses for the Companies, for intervening environmental advocates and for customer representatives. *See, e.g., id*. at 150, 159. Moreover, the governance and prudence issues Staff raises are addressed by the ALJPO's adoption of revisions to the

governance structure accepted during the course of the case by the Companies, in response to concerns stated on the record. *See* ALJPO at 171.

VIII. COST OF SERVICE

B. Embedded Cost of Service Study

2. Contested Issues

a. Coincident Peak Versus Average and Peak Allocation Methods

The ALJPO properly rejects the Companies' proposal to allocate demand-related costs using the Coincident Peak ("CP") method, adhering to the longstanding Commission policy of using the Average and Peak ("A&P") allocation method. ALJPO at 185-186. As the ALJPO finds, the record presents no persuasive reason to depart from that policy in this case. *Id.* at 185.

The Companies' Brief on Exceptions does not show otherwise. In particular, the Companies' attempt to minimize the significance of the Commission's"recent history" of using the A&P method fails. PGL-NS BOE at 72. The undisputed fact is that the Commission has applied the A&P method in "virtually every [ICC] natural gas delivery service rate case in the past ten years." City-CUB Ex. 1.0 at 74, L. 1792-94; *see also* Staff Init. Br. at 229-30. As NS-PGL witness Amen acknowledged, among those cases are the Companies' last rate cases. PGL Ex. RJA-1.0 at 17; NS Ex. RJA-1.0 at 17. Nor is it of any consequence that the Commission adopted the CP method in some cases in the early 1990s (*see* NS-PGL BOE at 72-73); the Commission abandoned that approach more than a decade ago in favor of the A&P method. Therefore, that past practice cannot fairly be characterized as the Commission's settled policy.

Nor does the Commission's approval of a variant of the CP method to allocate costs in recent electric utility rate cases warrant departing from established policy in this case. Even assuming *arguendo* that the electric utility cases merited consideration in this natural gas rate case, those cases hardly reflect an unequivocal policy of using peak demand alone to allocate distribution investments in that context. Specifically, as the Companies note (PGL-NS BOE at 73-74), the Commission indicated in ComEd's last rate case that it "remains open to considering the merits of adopting the P&A allocation factor." *In re Commonwealth Edison Co.*, ICC Docket No. 05-0597, Order at 172 (July 26, 2006). Moreover, in support of using such an allocator, the Commission noted that it "previously adopted the A&P allocation factor for distribution costs in natural gas rate cases . . ." *Id.* While that statement counsels in favor of reconsidering the proper allocation method for electric distribution utilities, it does not, as the Companies would have it, do so with respect to LDCs.

Equally meritless is the Companies' contention that using a peak demand allocator appropriately allocates costs to cost causers. *See* PGL-NS BOE at 74. Although it was included in City-CUB's prior briefs, the Companies make no mention of a crucial fact: the Companies' claim that distribution costs are incurred entirely to meet peak demand was contradicted at the evidentiary hearing by the Companies' own operations witness, Edward Doerk. *See* City-CUB Init. Br. at 94-97; City-CUB Reply Br. at 54-55. Specifically, Mr. Doerk acknowledged under cross-examination that (1) the Companies do not always immediately construct new facilities to meet increased customer demand that exceeds existing capacity, and (2) the Companies' system capacity design decisions are based on both the demands of customers at the system peak and the load supplied to customers over periods more inclusive than just the

system peak. *See* Sep. 10, 2007 Tr. at 210-14. Similarly, Staff witness Luth explained that"there are costs associated with putting a distribution system in place and operating the system, regardless of capacity, that are not affected by a change in capacity." Staff Ex. 19.0 at 6-7; *see also* CUB-City Ex. 2.0 at 28. Thus, the ALJPO's rejection of the Companies' proposal to allocate distribution costs based solely on peak demand is supported by the realities of the utilities' operations.

Nor is this the first time the Companies have cited operational considerations in support of their preference for the CP method. In fact, in the Companies' last rate case, the Commission concluded that

> [Peoples Gas] incorrectly assumes that all T&D investments are peak-related . . . . [The] CP allocator neglects the fact that T&D investments are driven by other factors as well. Factors such as repairs and investment to maintain reliability are examples of this.

In re Peoples Gas Light & Coke Co., ICC Docket No. 95-0032, Order at 43 (Nov. 8, 1995); *see also Abbott Labs. v. Ill. Commerce Comm'n*, 289 Ill. App. 3d 705, 716-17 (1st Dist. 1997) (affirming, as based on substantial evidence, Commission's adoption of A&P allocation method for Peoples Gas and North Shore). As the ALJPO correctly recognizes, the Companies have offered no reason to resolve the same cost-causation argument differently in this case.

Finally, the Commission should not be misled by the Companies' intimation that two recent Commission decisions applying the A&P method are unreliable because in one case, the utilities did not propose using the CP allocator, and in the other, no party recommended applying that allocation method. PGL-NS BOE at 75. That, in the 2004 Nicor Gas rate case, the utility did not propose the CP method is utterly inconsequential. The fact is that an intervenor in that case did propose using that method instead of the A&P method, and the Commission rejected the

intervenor's proposal. *See N. Ill. Gas Co.*, ICC Docket No. 04-0779, Order at 101-102 (Sept. 20, 2005) (reiterating that some distribution investments are not peak-related). As for the Ameren utilities' 2002-03 rate cases, although no party proposed adopting the CP method, the utilities did propose another allocation method (the A&E allocator), which gives predominant weight to peak demand. The Commission rejected that proposal, concluding that, "in light of the nature in which the transmission and distribution systems are used and because of the relatively declining cost of increasing capacity, peak demand is not the appropriate emphasis in allocating demand costs." *Cent. Ill. Pub. Serv., et al.*, ICC Docket Nos. 02-0798, et al. (cons.). Logically, the Commission's rejection of the A&E allocation method on the ground that it weighted peak demand too heavily implicitly extends to the CP method, which gives ***exclusive*** weight to such demand.

The ALJPO appropriately follows the Commission's settled policy of applying the A&P method for allocating distribution costs. Accordingly, the Companies' challenge to that portion of the ALJPO is meritless and should be rejected.

d. Allocation of Distribution Plant Account No. 385

The ALJPO properly rejects the Companies' proposal to assign to S.C. Nos. 2 and 4 costs recorded in FERC Account No. 385, finding "far more persuasive" GCI's recommendation to directly assign such costs to the individual customers causing the costs. ALJPO at 198. The ALJPO finds in particular that "[w]here, as here, the Utilities have the capability to identify the specific plant costs of meters, regulators and services with individual customers, . . . we consider it appropriate to rely on those attributes." *Id.* The ALJPO adds that GCI's proposal is "fair in

implementation" and consistent with the goals of "simplicity, understandability, certainty and feasibility of application." *Id.*

The Companies challenge the ALJPO's rejection of their allocation proposal on two grounds, neither of which has merit. First, the Companies maintain that because they could assign plant costs of meters, regulators and services to individuals in all service classifications, directly assigning Account No. 385 costs would unfairly "single out" the causers of such costs. As argued in City-CUB's prior briefs, the Commission should not be distracted by the Companies' allusion to other costs which (they claim) could also be directly assigned to individual customers. Other customer-specific costs – which may not be as highly specialized and unique to individual customers – are not at issue here. *See* City-CUB Init. Br. at 99-100; City-CUB Reply Br. at 63. Similarly, the Commission should give no weight to the Companies' suggestion that the rate impact of directly assigning Account 385 costs would be relatively small. *See* PGL-NS BOE at 78. The cost impact of following sound cost allocation principles is not a basis for ignoring them. *See* ALJPO at 198.

Second, the Companies raise a new contention omitted entirely from their testimony and prior briefs. In particular, they assert that it would be impractical to impose a "facilities charge" or "metering surcharge" on customers causing Account 385 costs because doing so would require them to develop a "specific rate" for each such customer. PGL-NS BOE at 79. Designing such rates would be complicated, the Companies continue, because the cost causers may change service classifications; Peoples Gas may retire or replace the Account 385 facilities included in the test year; and no party has explained how to design the charges. *Id.* At the threshold, the

Commission should decline to consider this argument because it includes no citation to the record and was not raised previously. *See* 83 Ill. Adm. Code § 200.800(a).

Even setting aside that procedural default, the Companies' argument does not warrant modifying the ALJPO. Tellingly, the Companies do not assert that they are unable to develop customer-specific rates for customers requiring Account No. 385 facilities; they only assert it would not be straightforward. But the PUA's requirement that rates be just and reasonable does not contain an exception for rates that are not easy to design. *See* 220 ILCS 5/9-101. Moreover, the Companies' suggestion that the ALJPO and the GCI should have provided guidance on the rate design question of how to implement direct assignment fails. Rather, the Companies should not have assumed in designing rates that the ECOSS's assignment of Account No. 385 costs to entire service classifications rather than the individual cost causers would be approved.

The ALJPO properly concludes that the costs recorded in Account No. 385 can and should be assigned to the customers causing such costs. Because the Companies have not established otherwise, the ALJPO's resolution of this issue should stand.

XIII. CONCLUSION

For the reasons discussed in this Reply Brief on Exceptions, the City and CUB respectfully request that the Commission reject the Companies' proposed exceptions and Staff's proposed EEP exception to the ALJPO.

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Respectfully Submitted,

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